Lonsec

Portfolio Perspectives

Insights from the CIO Office
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Key Messages for Investors

- Macroeconomic conditions are decelerating, but the impact is not evenly felt.
- The 2-Speed Australian Consumer reflects our assertion that the wealthiest portion of the country is carrying the aggregate economy.
- Even between nations, the relative economic performance is widening.
- The best examples of the haves and have-nots are the S&P500 and the Magnificent 7 (M7). Considering the US market as a whole, it looks very expensive, but when you break out the M7, a very different picture emerges.
- Now is the time to use active managers in your clients' portfolios, abide by the rules of diversification, and speak to your clients to ensure their portfolios align with their financial goals.

Market averages are only telling part of the story as to how this stage of the cycle is unfolding. Macroeconomic conditions are decelerating, but the impact is not being felt evenly among households, countries, or markets.

The 2-Speed Consumer

If you follow the news headlines, Australia is suffering a cost-of-living crisis. However, upon deeper examination, the consumer is not as homogenous as the headlines imply. Some parts of society are most certainly struggling, but this highlights a key observation we have for the Australian market: there is a two-speed consumer. First, services are the primary driver of the Australian economy, accounting for about 80% of GDP – this means our economy is heavily influenced by how people spend, much more so than how much iron ore we dig up, for example. Second, the distribution of wealth and debt is uneven in Australia. If you partition the entire population into five even groups (quintiles), the fourth and fifth quintiles, representing the wealthiest 40% of the Australian population, hold 64% of the debt and 63% of the gross disposable income. Using the Commonwealth Bank data as a proxy for the financial health of households, credit card arrears are currently 0.55%, flat for the last two years and still well below pre-Covid levels. Similarly, mortgage arrears at 0.47% are near their lowest in the previous ten years.

This means our nation's debt is mainly in the hands of those who can currently still afford it, and they are not struggling to pay their debts.

Third, what are the wealthiest parts of society doing? We do not have more recent data, but coming out of Covid to the end of 2022, the top 40% accounted for 56% of national consumption versus only 26% for the bottom 40%. Stated differently, the wealthiest 40% of the population consumes more than twice that of the poorest 40%.

Looking at more recent data, for the first two quarters of this year, aggregate consumer spending was up 10% and 8% year over year (YoY). In addition, retail sales in September are up 2% YoY – but remember that September 2022 was up nearly 18% YoY, so rising another 2% off such a high base level is quite remarkable. We also observe that year to date, Australians, in aggregate, have paid down their credit card balances by 4%. We believe this disparity between the wealthiest and poorest members of society speaks to the two-speed consumer: one group with the resources to weather the increasingly difficult macro environment and another who can not. We assert that this wealthier group is keeping the economy up in aggregate for now. The two-speed consumer means that while many Australians are doing it tough, an equal number continue to spend and stay on top of debts despite the RBA raising interest rates from zero to 4.35%.

Un-synchronised global growth

Globally, the dynamic between those doing well and those not, is also apparent. Looking at the Developed World (US, Japan and Europe still make up 49% of global GDP), there is a clear de-synchronisation in global growth, with Europe slowing the fastest, followed by Japan. The US on the other hand, is going from strength to strength and is forecast to grow profits by more than 10% next year, the only one in this group at double digits (Europe trails the group at -3%). We observe these relative fortunes can also explain the valuation discrepancies we see across regions, with Europe on a forward PE of 14x, Australia at 15x, Japan at 19x and the US at 20x.

The dichotomy of the US market

Before we get too carried away by the market momentum that continues to bid the US markets higher, we again note that everything is not what it seems. Some facts to remember about the S&P500 Index and the Magnificent 7 (M7):

- The M7 represents 29% of the market capitalisation of the S&P500.
- Technology-related stocks within the M7 comprise 94% of the market capitalisation weight of this group (Tesla is still just a car company!).
- The M7 is net cash, meaning that after they pay off any debt they might have, they still have cash left over. This also means higher borrowing costs do not directly impact their earnings.
- The average forecasted earnings growth for the M7 is 44%, which means the rest of the S&P500 has an average forecasted earnings growth of -3.3%.
- The average PE ratio of the M7 is 28x, putting the rest of the index at 17x, which makes the overall US market only slightly expensive when reflecting on the abovementioned multiples for Europe.
- The overall Technology sector of the S&P500 has a Return on Equity 63% higher than the index average (31% versus 19%). Technology companies get significantly more out of their balance sheet than their index peers. Considering the generally low leverage levels (recall high cash balances) amongst Technology companies, that is a remarkable use of shareholder capital, further justifying this group's valuation multiples.

The S&P500, like so much else we are observing in markets, is seemingly disconnected from reality. However, upon closer examination, it is increasingly falling on fewer and fewer actors to keep markets and the broader economy going.

We opened by noting that macroeconomic conditions continue to decelerate, consistent with our ongoing thesis that we have entered the end of this cycle. However, beyond just trying to identify the point where we will begin to shift our portfolios into more of a defensive posture, we note that the cycle is impacting different groups, regions and even stocks, well, differently. Without a consensus or majority of factors moving negatively and few signs that this "muddle through" situation breaks into a definitive trend, we continue to hold a cautious but not bearish stance on markets.

This remains the time to consider active managers in your clients' portfolios to deal with the various idiosyncratic trends in different markets. Diversification also remains an essential tool to manage portfolio risk. Lastly, work with your clients to ensure their financial plans and risk profiles reflect their long-term goals. We know the cycle is aging, but a few more tricks could still be up its sleeve.

Outlook and Positioning

Looking forward, watch the Australian dollar for further strength after we rolled out hedging in our portfolios; Japanese Government Bonds response to the Bank of Japan winding back Yield Curve Control (YCC); the holiday shopping season for signs of consumer stress (or not); and potential stabilisation in the Chinese property market.

Growth Assets	Underweight			Neutral	Overweight		
Australian Equities				●			
Large Caps				●			
Small Caps				●			
Developed Market Equities			●				
Small Caps				●			
Emerging Market Equities				●			
Australian Listed Property				●			
Global Listed Property				●			
Global Listed Infrastructure			●				
Growth Alternatives				●			
Defensive Assets	**Underweight**			**Neutral**	**Overweight**		
Australian Bonds					●		
Global Bonds				●			
Diversified Income					●		
Conservative Alternatives				●			
Cash				●			

Growth Assets

Asset Class	Position	Rationale
Australian Equities	Neutral	Macro conditions are softening but valuations remain 'fair'. FY24 earnings are expected to decline versus FY23, driven by the banks and resources, before rebounding in FY25. Ongoing strength in iron ore prices represents upside risk to earnings next year.
Developed Market Equities	Slight Underweight	Global equity valuations appear more stretched, particularly in the US, thanks to the stellar outperformance of the Magnificent 7 this year.
Emerging Market Equities	Neutral	Valuations look attractive with much of the bad news around China priced in. Risks to the upside should further Chinese stimulus be forthcoming.
Australian Listed Property	Neutral	Still adjusting to a higher for longer interest rate environment, but valuations are attractive enough to maintain a neutral position. Highly nuanced depending on sub-sector, with the office sector in particularly remaining structurally challenged.
Global Listed Property	Neutral	Same dynamics at play as Australia.
Global Listed Infrastructure	Slight Underweight	Higher for longer interest rate environment presents a headwind for this sector given the leverage typically associated with these companies. Better risk/return opportunities in defensive assets for investors seeking yield.
Growth Alternatives	Neutral	Prefer liquid multi-strategy hedge funds over private market exposures where further repricing is expected. The Australian Dollar is now considered 'cheap' so we are building in foreign exchange hedges to assist in managing currency risk.

Defensive Assets

Asset Class	Position	Rationale
Australian Bonds	Slight Overweight	Bond yields are now offering good value and bonds can once again play a defensive role in diversified portfolios.
Global Bonds	Neutral	Supply/demand imbalances in the US treasury market remain a focus, reducing their relative preference versus Australian government bonds. Also, the expected gradual unwinding of yield curve control policy in Japan should lead to an extended period of relative underperformance in Japanese Government Bonds.
Diversified Income	Slight Overweight	Floating rate yields remain higher than fixed rate yields.
Conservative Alternatives	Neutral	Gold acts as a risk-diversifier against a further deterioration in economic conditions or escalation in geopolitical tensions.
Cash	Neutral	Provides short term liquidity with a modest yield.